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No. 88-2105

In the Supreme Court of the United States

OCTOBER TERM, 1989

THOMAS J. DURKIN, ET AL., PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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QUESTIONS PRESENTED

1. Whether the courts below properly found that Paramount, which retained all substantial attributes of ownership of certain motion picture films, was the owner of those films for income tax depreciation purposes, even though limited partnerships in which petitioners had invested had acquired bare legal title to the films.

2. Whether the court of appeals correctly applied the clearly erroneous standard in reviewing the Tax Court's findings with respect to whether the partnerships or Paramount possessed the benefits and burdens of ownership.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-13a) is reported at 872 F.2d 1271. The opinion of the Tax Court (Pet. App. 15a-89a) is reported at 87 T.C. 1329.

JURISDICTION

The judgment of the court of appeals (Pet. App. 14a) was entered on April 5, 1989. The petition for a writ of certiorari was filed on June 23, 1989. The jurisdiction of this Court rests upon 28 U.S.C. 1254(1).

STATEMENT

1. The issues in this case stem from investments made by petitioners in Balmoral Associates and Shelburne Associates, which were limited partnerships that reported losses during the years 1977 through 1980 in connection with

their alleged ownership of six motion picture films. These films were purportedly acquired as a result of a circular series of transactions involving Paramount Pictures Corporation, Film Writers Co. (FWC),[1] and the two partnerships (Pet. App. 4a).

Three agreements were executed for each film (Pet. App. 4a-5a, 22a-43a). Under the first agreement in each case, Paramount "sold" the film to FWC at a purchase price equal to Paramount's direct cost plus an overhead charge, payable chiefly by long-term nonrecourse promissory notes (*id.* at 4a, 22a-28a). Under the second agreement in each case, FWC conveyed the film to one of the partnerships (on the same date that it acquired it) at a purchase price equal to FWC's cost plus a mark-up, payable primarily by means of long-term promissory notes that purported to be recourse (*i.e.*, debt for which the limited partners were personally at risk within the meaning of Section 465 of the Internal Revenue Code[2]), but that in fact would convert to nonrecourse upon occurrence of an event that was certain to happen (Pet. App. 9a-11a, 28a-33a)[3].

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[1] FWC was a wholly owned subsidiary of World Film Services, Inc., a British Corporation engaged in the film business, which was, in turn, owned and controlled by John Heyman. Heyman was a longtime business associate of Calvin Eisenberg, the attorney responsible for organizing the partnerships in question (Pet. App. 19a-20a). As found by the Tax Court (*id.* at 62a-68a), FWC served merely as a conduit in the transactions in question—it "did nothing for the partnerships except create some purportedly recourse debt" (*id.* at 67a).

[2] Unless otherwise noted, all statutory references are to the Internal Revenue Code of 1954 (26 U.S.C.) (Code), as in effect during 1977 through 1980, the years at issue.

[3] For instance, the purchase agreement for "First Love" executed by Balmoral and FWC provided that the note would become 50% nonrecourse when the distributor's gross receipts from the United States equaled $1,500,000 and in all other territories equaled $1,500,000; such note would become 100% nonrecourse when the distributor's

Upon acquisition of each film, the partnership involved immediately entered into an agreement with Paramount (the distribution agreement). Under these last agreements, the partnership irrevocably granted Paramount the exclusive worldwide right to distribute, exhibit, market, reissue and otherwise exploit the six films for a 28-year period in return for a small percentage of Paramount's gross receipts. The distribution agreements were renewable in perpetuity for successive 28-year periods upon payment by Paramount of nominal renewal fees. Pet. App. 4a-5a, 33a-43a. Thus, under the three agreements relating to each film, Paramount, the original owner, wound up with the right to copy, distribute, and exhibit the films, the right to make any motion picture sequels, and the right otherwise to exploit the dramatic material contained in the motion pictures (*id.* at 6a, 55a).

On their individual income tax returns, the Durkins claimed investment tax credits and deductions for depreciation and other expenses for taxable years 1977 through 1980 attributable to their interest in Balmoral, and the Grossmans claimed investment tax credits and deductions for depreciation and other expenses for taxable years 1978 through 1980 attributable to their interest in Shelburne. In his notices of deficiency, the Commissioner

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worldwide gross receipts equaled $5,000,000. Alternatively, the note would become 100 percent nonrecourse upon receipt by the distributor of the sum due it upon the first syndicated television broadcast of the picture, an event virtually certain to occur (Pet. App. 9a, 28a-29a). The purchase agreements for the other films contained comparable provisions (*id.* at 29a-32a). As of the time of trial in September 1984, all of the partnerships' long-term notes had converted from recourse to nonrecourse except those relating to "Bad News Bears Go to Japan" (*id.* at 51a).

disallowed these credits and deductions (Pet. App. 52a).[4] Petitioners sought redetermination of the deficiencies in the Tax Court.

2. Petitioners' cases were consolidated for trial, briefing and opinion. After a nine-day trial, the Tax Court determined that the partnerships had not acquired "ownership" of the six films in question, and thus could not claim depreciation with respect to the films. Rather, the Tax Court found, the net effect of the acquisition, purchase and distribution agreements was that Paramount retained virtually all of the rights and liabilities generally associated with ownership, and the partnerships were left simply with contractual rights to participate in Paramount's gross receipts and profits (Pet. App. 54a-58a). The court, however, determined that the partnerships' contract rights in Paramount's gross receipts and profits constituted intangible assets that would be exhausted over time, so that the partnerships were entitled to amortize their bases in those contract rights, using a "straightline" method (*id.* at 58a).[5]

The court further ruled that the long-term "recourse" notes were not includible in the partnerships' cost bases subject to amortization. The court found that the notes were designed to create the *appearance* of "risk" within the meaning of Code Section 465 but, in actuality, were vir-

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[4] The Commissioner's notices of deficiency for 1977 and 1978 disallowed petitioners' claimed losses and investment tax credits from the partnerships on grounds other than lack of any beneficial ownership of the films. That latter ground of disallowance was asserted prior to trial by amendment of the Commissioner's answers in the Tax Court. The notices of deficiency for 1979 and 1980 did base disallowance upon the lack of beneficial ownership (Pet. App. 53a). Petitioners' assertion (Pet. 3) that the Commissioner initially concurred with their position with respect to ownership is accordingly inaccurate.

[5] Section 167(c) of the Code prohibits the use of accelerated methods to compute the allowable amortization expense for intangible assets.

tually certain to convert to nonrecourse (Pet. App. 64a-67a). Moreover, the court found, Heyman—whose testimony on this point the Tax Court did not believe (*id.* at 67a)—was not dealing at arm's length with Eisenberg and the partnerships,[6] and would not under any circumstances have sought to enforce the personal guarantees of the long-term notes made by petitioners or the other limited partners (*id.* at 66a-67a). Consequently, the court concluded that "the partnerships' long-term notes and the guarantees of the limited partners were without business purpose and executed solely to gain tax benefits" and must therefore be disregarded for tax purposes (*id.* at 64a). Finally, the Tax Court found that the "true" cost of the movies equalled the cash and short-term notes issued by the partnerships (*id.* at 68a), and that the total $41 million amount for which the partnerships were purportedly at risk "clearly exceeded the fair market value of the rights the partnerships received" (*id.* at 66a).[7]

3. The court of appeals affirmed (Pet. App. 1a-13a). After reviewing the testimony and documents in the record, the court concluded that the Tax Court's findings that the rights retained by the partnerships were too insubstantial to qualify as ownership were not clearly erroneous (*id.* at 6a-7a). The court distinguished these transactions from a bona fide sale-leaseback where the purchaser-lessor retains a depreciable ownership interest in the asset. It first pointed out that "[i]n either sale-leasebacks or the transactions at issue here, the court must determine, after the dust settles, in which party the benefits and risks of ownership rest" (*id.* at 7a). Here, the court

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[6] See note 1, *supra*.

[7] Petitioners therefore err in asserting (Pet. 5) that "the Tax Court did not make any specific finding of fact that the purchase price was unreasonably inflated."

concluded, Paramount had retained those benefits and risks and should be treated as the owner (*id.* at 6a-7a). The court also agreed with the Tax Court that (for amortization purposes) the partnerships' bases in their contractual rights to share in the profits from the films were limited to the amount of their cash payments and the amount of their short-term notes (*id.* at 8a-11a). The court agreed with the trial court's conclusion that the long-term notes were actually nonrecourse from inception, since the events triggering conversion from recourse to nonrecourse status were almost certain to occur, and since any payments of principal were to be made solely out of profits (*id.* at 9a-10a). In the court's view, the partnerships represented "classic tax shelters," because the purchase price, inclusive of the long-term debt, unreasonably exceeded the value of the contract rights of the partnerships and did not, therefore, constitute genuine indebtedness includible in the partnerships' bases for amortization purposes (*id.* at 10a).[8]

ARGUMENT

The courts below correctly determined that despite the partnerships' retention of bare legal title, Paramount, rather than the partnerships, was the beneficial owner of the films in question. The courts below also correctly determined that the partnerships' bases for amortizing their contract rights in Paramount's profits did not include the long-term "recourse" notes. Further, the court of appeals applied the proper standard of review in reaching its decision. The court of appeals' holding is fully consistent with the decisions of this Court, and it does not conflict with any decision of another court of appeals. Accordingly, there is no reason for review by this Court.

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[8] The other issues decided by the Tax Court and the court of appeals are not raised in the petition.

1. Petitioners take issue with the authority of the Commissioner and the courts to look through any aspect of the form of a transaction entered into by a taxpayer where the Commissioner does not dispute that the taxpayer had an overall profit motive for entering into the transaction. In particular, petitioners contend that the Commissioner and the courts erred here when they refused to accept for tax purposes the partnerships' claim to ownership of the films and related copyrights, determining instead that the partnerships merely acquired contractual rights to share in the profits contingent on the films' success.

This contention is without merit. It is axiomatic that the economic substance of a transaction, rather than its form, governs whether a transaction is a bona fide sale for income tax purposes. See *Gregory* v. *Helvering*, 293 U.S. 465, 470 (1935); *Commissioner* v. *Court Holding Co.*, 324 U.S. 331 (1945). This Court has repeatedly refused to permit the transfer of formal legal title to shift the incidence of taxation attributable to ownership of an asset where the transferor continues to retain significant control over the asset transferred. *E.g.*, *Frank Lyon Co.* v. *United States*, 435 U.S. 561, 573 (1978) (Court looks to "the objective economic realities of a transaction rather than to the particular form the parties employed"); *Helvering* v. *Clifford*, 309 U.S. 331 (1940); *Commissioner* v. *Sunnen*, 333 U.S. 591 (1948). The Court has specifically held that beneficial ownership rather than formal legal title is the basis upon which deductions for depreciation are allowable. *Helvering* v. *F. & R. Lazarus & Co.*, 308 U.S. 252 (1939). "[T]axation is not so much concerned with the refinements of title as it is with actual command over the property taxed — the actual benefit for which the tax is paid." *Corliss* v. *Bowers*, 281 U.S. 376, 378 (1930). The Commissioner and the courts below, therefore, did not exceed their authority

in examining the objective economic realities of the transactions in question to ascertain whether their substance was consistent with the form in which the parties cast them.

Based on that examination, the Tax Court and the court of appeals correctly determined that, apart from hollow legal title, the partnerships retained virtually none of the benefits and burdens traditionally associated with ownership of an asset. The partnerships had essentially no possessory rights over the films, almost no control over how the films were exploited and only a small participation in profits from their exploitation. Because all significant ownership rights were held by Paramount, the courts correctly found that Paramount was the real owner of the films and the partnerships simply enjoyed contractual rights to participate in their earnings.[9]

Petitioners argue (Pet. 6-8) that the courts' examination of the substance of the transactions to ascertain whether they corresponded with the form in which they were cast by the parties conflicts with the doctrine established in *Frank Lyon Co.* v. *United States,* 435 U.S. at 583-584, where the Court indicated that the form in which a trans-

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[9] The courts below also correctly determined that the partnerships' bases in those contract rights for amortization purposes did not include the amount of the long-term notes. In this regard, the Tax Court found that the notes were nonrecourse *ab initio* because of the certainty that the conversion events would happen and because the "recourse" features were merely added to lend the notes the *appearance* of risk within the meaning of Section 465 of the Code in an attempt to inflate the partnerships' bases in the films. The Tax Court also found that the principal of the notes was payable solely out of earnings and the purchase price paid for the contract rights, inclusive of those notes, unreasonably exceeded the fair market value of the rights acquired, thereby compelling the conclusion that the notes did not constitute genuine indebtedness and could not be included in the partnerships' bases in those contract rights (Pet. App. 62a-68a).

action is cast by the parties will generally control so long as it is compelled by business or regulatory considerations rather than tax-avoidance motives. That case is clearly distinguishable from the case at bar, however.[10] The transaction in *Frank Lyon Co.* was a genuine multiple-party transaction with economic substance compelled by regulatory realities and other nontax considerations. Unlike the partnerships here, the Frank Lyon Company undertook a significant financial risk as a consequence of investing its capital in the construction of the building. For those reasons, the Court refused to recast the transaction. In the case at bar, by contrast, when the formalisms designed "to

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[10] *Frank Lyon Co.* involved a bank that wanted to construct a new building but was prohibited by state and federal regulations from incurring the debt necessary to finance the project. The Frank Lyon Company, a third-party investor that was willing to incur the risk of obtaining a loan to pay for construction of the building, agreed with the bank to enter into a sale and lease back under which Frank Lyon Company was to be treated as the owner-lessor of the building in progress.

Frank Lyon Company asserted that it was the owner of the building for tax purposes (and was thus entitled to claim depreciation and other deductions), and this Court upheld its position. Emphasizing that Frank Lyon Company had risked "its very business well-being" by assuming primary liability for the construction loan, the Court concluded that Frank Lyon Company, and not the user-bank, owned the building for depreciation purposes. 435 U.S. at 576-580. The Court stated (*id.* at 581):

> As is clear from the facts, none of the parties to this sale-and-leaseback was the owner of the building in any simple sense. But it is equally clear that the facts focus upon Lyon as the one whose capital was committed to the building and as the party, therefore, that was entitled to claim depreciation for the consumption of that capital. * * * We therefore conclude that it is Lyon's capital that is invested in the building according to the agreement of the parties, and it is Lyon that is entitled to depreciation deductions, under § 167 of the 1954 Code * * *.

produce the appearance of 'risk' within the meaning of section 465" (Pet. App. 6a-8a, 66a) are peeled away, the partnerships at bottom received only "bare legal title" to the films. The Tax Court was accordingly correct in concluding that the transactions "were without business purpose and executed solely to gain tax benefits" (*id.* at 64a), and the court of appeals agreed (*id.* at 10a).

Petitioners make much of the fact that the Commissioner conceded in the Tax Court that the partnerships had a profit motive in entering into the transactions in question (Pet. 4-7). But the profits that petitioners hoped to receive were limited to a share of the profits that Paramount, the beneficial owner of the films, would earn from *its* exhibition and distribution of the films. Obviously, the fact that a taxpayer expects to profit from his purchase of a right to share in another's profits does not entitle that taxpayer to claim depreciation with respect to property he does not own or to claim amortization based on bogus "recourse" notes. Rather, as held by the Tax Court, petitioners' rights in Paramount's profits entitled them only to deductions based upon the amortization of the true debt for which they were substantially at risk.[11]

2. Petitioners contend (Pet. 8-9) that it was error for the court of appeals to apply the clearly erroneous standard in reviewing the Tax Court's findings with respect to which party had the benefits and burdens of owning the

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[11] Had the Tax Court found that the partnerships here had not engaged in their activities with the intent to make a profit, petitioners and the other limited partners would have lost the ability to deduct not only the expenses relating to their long-term "recourse" notes but also those relating to their *cash* investments (except to the extent of gross income from those activities). See, *e.g.*, *Brannen* v. *Commissioner*, 722 F.2d 695, 705-706 (11th Cir. 1984).

films.[12] Although this Court indicated in *Frank Lyon Co. v. United States*, 435 U.S. at 581 n. 16 (in the course of giving deference to a particular trial court finding) that "[t]he general characterization of a transaction for tax purposes" is subject to *de novo* review, it further noted that "[t]he particular facts from which the characterization is made" are subject to the clearly erroneous standard. The clearly erroneous standard applies "even when the district court's findings do not rest on credibility determinations, but are based instead on physical or documentary evidence or inferences from other facts." *Anderson v. City of Bessemer City*, 470 U.S. 564, 574 (1985). See also *Pullman-Standard v. Swint*, 456 U.S. 273 (1982).

Petitioners took the position at trial that the partnerships possessed more of the benefits and burdens generally associated with ownership than did Paramount; the Commissioner took the opposite view. To support their respective positions, the parties called numerous witnesses to testify in the course of the nine-day trial and introduced many exhibits. In resolving the ownership issue, the Tax Court considered both the documentary evidence and the testimony in this case, including the testimony that Paramount would not have "sold" the films in question if it had not been able to retain the distribution rights (Pet. App. 43a, 56a). Based on this examination, the court found that under the purchase and distribution agreements, Paramount retained the worldwide rights to produce copies of the films, to control distribution and exhibition of the films, to produce film sequels, and otherwise to exploit any dramatic materials contained in the films, while the partnerships were simply left with bare legal title. Further,

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[12] Tax Court findings of fact, like district court findings of fact, are subject to the clearly erroneous standard of review. See *Commissioner v. Duberstein*, 363 U.S. 278, 291 & n. 13 (1960).

the Tax Court found that Paramount retained a far more substantial financial interest in the films than the partnerships acquired. The Tax Court determination that Paramount, and not the partnerships, was the beneficial owner of the films at issue here thus turned on its specific findings concerning the allocation of the significant attributes of ownership. In these circumstances, the court of appeals correctly applied the clearly erroneous standard of review. See *Massengill* v. *Commissioner*, 876 F.2d 616, 619 (8th Cir. 1989) ("The question of economic substance is essentially factual, and the Tax Court's finding is not to be disturbed unless clearly erroneous."); *Foster* v. *Commissioner*, 756 F.2d 1430, 1436 (9th Cir. 1985) (Tax Court's finding that taxpayer's "transaction was lacking in economic substance will not be set aside unless clearly erroneous."), cert. denied, 474 U.S. 1055 (1986); *Blueberry Land Co.* v. *Commissioner*, 361 F.2d 93, 100 n.21 (5th Cir. 1966) ("We can think of few things which are more factual than form versus substance. The subtle factors leading to a conclusion on this issue are factual in essence and for primary resolution by the trier of fact.").

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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